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STATE FOR SCA/INS JASHWORTH AND SCA/RA MURENA
USDOC FOR 4530/ITA/MAC/OSA/LDROKER/ASTERN
DEPT PASS TO USTR FOR SOUTH ASIA - CLILIENFELD/AADLER
DEPT PASS TO TREASURY FOR OFFICE OF SOUTH ASIA - MNUGENT
TREASURY PASS TO FRB SAN FRANCISCO/TERESA CURRAN

SENSITIVE
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TAGS: ECON EFIN EINV ETRD EAGR PREL PGOV PTER IN
SUBJECT: INVESTOR APPETITE FOR INDIA RETURNING BUT GOVT BETTER NOT DISAPPOINT

REF: NEW DELHI 1162

¶1. (SBU) Summary. Econoff and ConGenoffs met with Mumbai contacts on June 1 and 2 to gauge investor reaction to the elections and signs of recovery in the Indian economy. In contrast to reports at the beginning of 2009 that investors were waiting for political uncertainty to end with the May elections, contacts noted that investors have a "lot of money on the table" for foreign investment and India and China increasingly stand out among emerging market destinations. However, market observers and fund managers also cautioned that the recent rise in the bellwether Sensex stock index since elections has built in expectations of improved government performance and service delivery. If those heightened expectations are not met by the end of the year, contacts warned that the markets could retreat and foreign investors could rethink their currently bullish perspective on India. In the meantime, new GDP data (reftel) provided upbeat news, with the fiscal year that ended in March growing 6.7%, above expectations, raising some economists' outlook for the coming year.

Elections Have Improved Sentiment But Not Fundamentals

¶2. (SBU) Several investors pointed to the election results as the reason for the recent runup in the Bombay Stock Exchange, especially as tracked by the benchmark Sensex, which has risen more than 2000 points since the parliamentary election results were announced May ¶16. Krishnakumar G., Managing Partner, IL&FS Investment Managers Ltd., opined that market investors have perceived that the large gain in Congress seats will create a stable and solid coalition government absent the Left and inordinate influence by the regional parties. The Prime Minister's apparent firmness in limiting requested ministerial positions to one of the coalition partners who has underperformed was also well received. Similarly, Sreekumar Chatra of Macquarie Capital called it a decisive election. Blackstone Advisors India's Chairman and Managing Director, Akhil Gupta, went even further, seeing the election results as a "huge inflection point" for the country, where voters chose performance.

¶3. (SBU) Reflecting this outlook, institutional investors have raised their profile in India since the elections. Chatra estimated $2 billion had entered the country in the last two months in qualified institutional placements (QIPs), a highly liquid kind of equity purchase only permitted by stable, experienced funds like pension funds. Sanjay Agarwal of Bank of America's Investment

Banking Group noted that $5 billion came in foreign institutional investment (FII) flows in April and May, with $1 billion alone in the week after election results were announced. This was in sharp contrast to the previous fiscal year, where FIIs withdrew a net $10 billion. He also saw a substantial amount coming in the form of QIPs and expected that to continue in at least the short term.

¶4. (SBU) Contacts noted, however, that although sentiment has improved, India's fundamentals remain the same as several months ago, leaving in place several key constraints, especially governance and infrastructure. Vivek Kudva, President, Franklin Templeton Asset Management, claimed there was no rationale for the Sensex rise, as India still has issues. He pointed to poorly targeted subsidies, lack of "world class" infrastructure and the dampening effects of the global economic slowdown on India via the export channel. Blackstone's Gupta assessed the gap between India's potential and actual achievements as that of governance. He pointed to weakness in India's courts, where millions of cases are stuck, to poorly trained and incentivized police, and even to Parliament. However, the election results have made him very bullish and he anticipated political stability for at least the next ten years, and more stability than China.

5) (SBU) On infrastructure, Macquarie's Chatra anticipated there was $6-9 billion in international infrastructure funds ready to come into India, if the government could fix the project finance structures. He zeroed in on necessary amendments to the concession agreements the government offered to infrastructure developers, noting that the definition of total project cost was not viable, nor the bar on cross-holdings which disqualifies otherwise experienced developers. He viewed Kamal Nath's assignment to the Roads and Surface Transport Ministry as a positive step, given Nath's reputation for "efficiency and effectiveness." Overall, he thought

infrastructure ministries were looking strong. Shubhada Rao of Yes Bank said there was global interest in investing in India's infrastructure sector. She thought investors were "piqued by" government signals since elections, but that they needed to be confident of the policy framework and were looking for stability there.

Government Better Deliver

¶6. (SBU) Several interlocutors assessed that the markets have factored in expectations that a lot more will get done in this Parliamentary session than in 2004-2009. As such, many expressed the view that the government has 6-12 months to demonstrate progress, or else euphoria will turn to frustration and possible capital outflows. Vivek Kudva, President, Franklin Templeton Asset Management, does see a window now to push through reform, in the areas of tax and subsidy rationalization that could boost revenues and more effectively spend existing government funds. JP Morgan India Chief Economist Jahangir Aziz also saw a risk to sustained market levels if expectations are not met by December. Besides the strengthened position of the Congress party and the coalition, Aziz perceived that the Prime Minister, Finance Minister Mukherjee, Planning Commission Deputy Chairman Montek Singh Ahluwalia, and even Home Minister Chidambaram were nursing bruised egos because of their inability to deliver significant reforms before. This, according to Aziz, had increased their determination to achieve their goals, as it was probably the last chance for most of them, given their age.

¶7. (SBU) Others were more worried about the government's ability to deliver. Bank of America's Agarwal speculated that the West Bengal coalition partner, the Trinamool Congress, might act like the Left parties in blocking reform, while Kudva wryly noted that the ministerial assignments were encouraging, and they were a "good lot" of ministers, but they were also "the same lot" that was in the last government. Madhav Bhatkuly, Director of New Horizons Investments, also worried that corruption remained a serious impediment to effective governance and service delivery. Yes Bank's Chief Economist, Shubhada Rao stated that she had upgraded India's economic outlook after the elections. But she cautioned that the Congress party still needs to build consensus on reforms, even within the party, claiming that the government had "no other choice but to perform." However, she was upbeat about new Finance Minister Mukherjee, describing him as open to reason, candid and honest.

Government Borrowing Problematic

¶8. (SBU) Kudva pointed out that government yields have risen since the elections, anticipating significant government borrowing to address a large fiscal deficit. Macquarie's Chatra looked to University of Chicago economist Raghuraman Rajan's assessment that there was not much additional impact to be gained from further monetary and fiscal stimulus. Deosthalee of Larsen and Toubro and Bank of America's Agarwal felt it was imperative that the government get its "fiscal house in order". The markets need clear signals from the government on its borrowing plans, they said, since the huge deficit suggests heavy borrowing in the months ahead. Deosthalee saw that just the anticipation of the government's needed borrowing has already created upwards pressure on government yields. Agarwal anticipated that the large size of the council of ministers would make it harder to rein in expenditures, since there would be more demands for funding. Yes Bank's Rao noted that the central bank was signaling the end of its loose monetary policy and that crowding out had not yet happened because of subdued domestic corporate demand, implying crowding out could become a problem in the near future as the economy improved.

Economic Outlook

¶9. (SBU) Franklin Templeton's Kudva is skeptical that the Indian economy is yet out of the woods, feeling that the government salary raises last year under the Pay Commission artificially and only temporarily boosted consumer power. Krishnakumar observed that sea freight container traffic to India is still about half of what it was at its height in 2008, so that port activity and road traffic is still lower than some investors find attractive. He expects another

year or two before traffic recovers. JP Morgan's Aziz does not think there is sufficient domestic demand to sustain higher economic growth beyond 6-12 months. He thinks the decent GDP growth rates of the last six months have come from government workers spending more from their Sixth Pay Commission salary increases, which will not sustain growth, a view echoed by New Horizons' Bhatkuly. Aziz anticipated that, by the second half of 2010, India will need the global economy to recover and boost exports in order for its GDP to sustain growth above 7 percent. Some interlocutors, though, were more upbeat. Macquarie's Chatra said that his firm had raised its India GDP projection for FY10 after the elections to 7%. Likewise, Yes Bank's Rao noted her upward bias on a 6% growth projection, saying she needed a "clearer picture of agriculture" before raising the projection. She expected Indian company expansion plans to go slowly, as global demand was key to many of the expansion projections.

Investment Outlook

¶10. (SBU) IL&FS' Krishnakumar said that in his recent roadshow meetings with several hundred European investors, he saw a focus on India and China as the only two countries still growing. As such, whether India's growth rate was 6% or 7% was of lesser concern, since no other country besides China was close to that kind of growth rate. While investors are re-examining emerging markets after 9 months, Krishnakumar also noted that the economic slowdown is generating new opportunities in Canada and Europe with rare, attractive 8-10% returns, noting that country risk in India requires 20-25% returns. When asked if India was rising in investor estimation given its current higher growth, Agarwal temporized, placing India as a new "star" in emerging markets portfolios, but not breaking free from that category. Agarwal looked to the third quarter of 2009 for capital markets to really open for the US, followed by Europe, then lastly by emerging markets.

¶11. (SBU) Kudva still does not yet see long term funds coming into the markets. Agarwal also noted the lack of medium and long term financing, seeing only 2-3 year short-term money available in the market right now. He noted this is especially detrimental for infrastructure financing, which needs such long-term financing to

match the 10-20 year gestation period of projects. Agarwal estimated that banks have put $20-25 billion in mutual funds in the last few months, rather than on-lend, because of concerns over credit quality. Larsen & Toubro's Chief Financial Officer, Y Deosthalee, echoed that, lamenting that long term project finance in the West has not yet adequately improved. He acknowledged that availability has increased somewhat but affordability of foreign financing is still a problem. Deosthalee pointed to the government-administered high-interest savings schemes that capture much of long-term savings, preventing them from becoming long term lending instruments. For Gupta of Blackstone as well as Yes Bank's Rao, they saw the Budget, expected in July, as a major signal to investors of government priorities, including how to handle the budget deficit.

Comment

¶12. (SBU) Economists and investors in Mumbai had mixed views on whether the economy was yet recovering, but most agreed that the next six months were critical for the government to signal ability, not just intent, to achieve policy goals. There was general agreement that the markets had risen too quickly and priced in performance, adding pressure to the government's need to demonstrate policy success or else see a retreat in foreign institutional investment. The election results had removed a major uncertainty to investors, but many seemed unwilling to more fully commit funds until the policy framework was made clearer. The government's stated priority for infrastructure development requires significant private (read foreign) investment and so the ball is now solidly in its court to convince foreign investors who stand poised to commit billions to India's future.

¶13. (U) Mumbai contributed to this cable.

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